FOUR HABITS OF HIGHLY SUCCESSFUL ADVISORS: PART THREE

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My colleague Ryan Krystopowicz and I recently co-wrote and posted to the WisdomTree website a white paper "think piece" entitled, "Four Habits of Highly Successful Advisors."[1] We are now "serializing" that white paper into four blog posts. In part 1, we discussed how to appropriately evaluate and build enterprise value by focusing on scale, efficiency and profitability. In part 2, we focused on the importance of client segmentation and niche branding. Here in part 3, we focus on the importance of optimizing fees and taxes—the two things an advisor has the most control over.

Habit Three: Optimize Taxes and Active Management Fees

It is a well-known market adage that the only investment aspects advisors really have control over are fees and taxes—they cannot control market movements.

Well, it's an adage because it's true. Optimizing fees and taxes represents putting real money back into the pocket of your clients—ideally enough to cover your advisory fee and then some.

Optimizing Active Management Fees

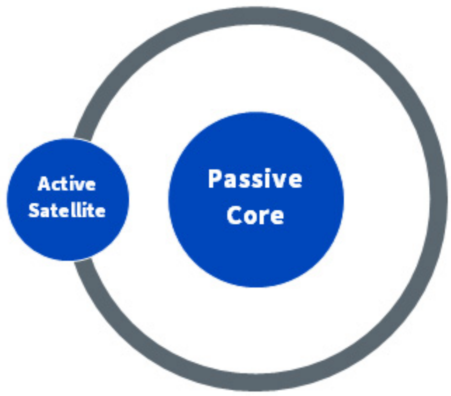
Most advisors are familiar with the concept of "core/satellite" portfolio construction (sometimes referred to as "core and explore"), but let's define terms so we are working from a similar framework.

The idea is to build an inexpensive and passive "core" portfolio, typically using ETFs, in an attempt to create a desired market exposure (or beta) portfolio in a cost- and tax-efficient manner. Then, that core portfolio is surrounded with actively managed "satellite" managers in an attempt to add net-of-fee outperformance (or alpha) to the overall portfolio. Historically, those active managers have come by way of mutual funds or, for larger clients, separately managed accounts (SMAs).

To understand the notion of adding alpha, we also need to remind ourselves of the concept of active risk.

Simplistically, active risk can be thought of as "bets" (over-weights, under-weights, factor tilts, etc.) an active manager takes away from the underlying benchmark to generate outperformance versus that benchmark.[2]

So, the goal of a core/satellite portfolio is to deliver cost- and tax-efficient outperformance relative to a defined benchmark (e.g., the S&P 500 index or the MSCI ACWI index for an equity portfolio).



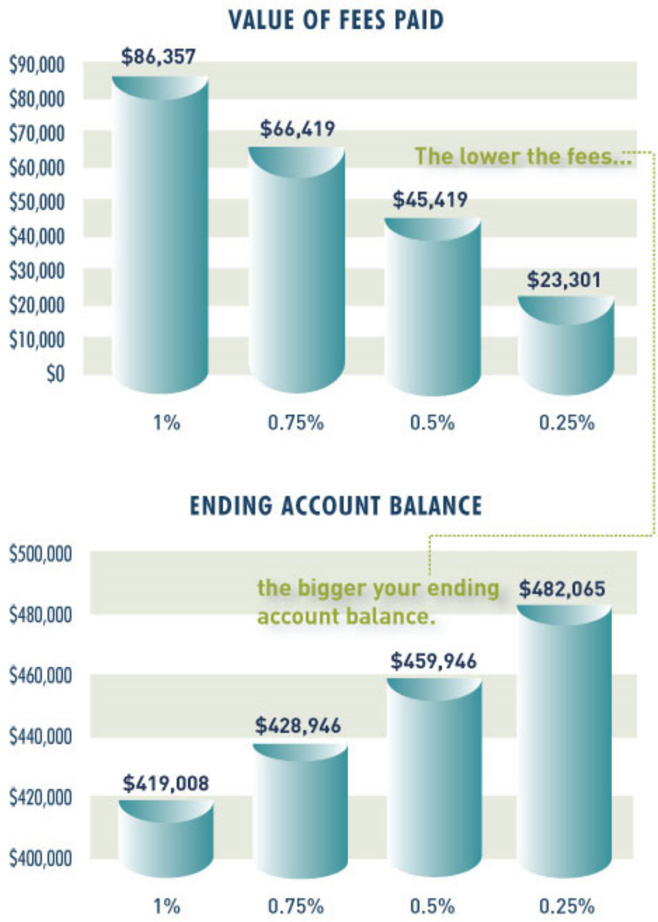
Source: WisdomTree. For illustrative purposes only. Does not represent investment advice.

Building a Better Mousetrap

Fees matter—especially over long-time horizons.

The asset-weighted average expense ratio for active funds was 0.60% in 2021. That is exactly five times the asset-weighted average expense ratio for passive funds (0.12%) at that time.[3]

The illustration below highlights just how much of a difference higher fee investments can make over time.



Source: https://weabenefits.com/resource/fees/. Illustration assumes an annual contribution of $5,000 and an annual rate of return of 7% over a period of 30 years. This is for illustrative purposes only and not indicative of any investment.

The satellite component of the portfolio historically was constructed using actively managed mutual funds and/or SMAs. But what if you could build the satellite portfolio with structurally advantaged ETFs? Enter the WisdomTree **Outcome Focused Model Portfolios**.

We built these Models with "satellite" very firmly in mind.

While they can be—and are—used as stand-alone Models, they were built specifically to complement already existing portfolios to achieve specific investment mandates.

Our Outcome Focused Models include:

- **Global Dividend**, an all-equity portfolio seeking to optimize both total return and risk-adjusted yield.
- **Multi-Asset Income**, a portfolio that, as described, includes stocks, bonds and other assets in an attempt to optimize both total return and risk-adjusted yield.
- **Multi-Factor**, an all-equity portfolio that seeks to improve the risk factor diversification of an overall portfolio while still generating positive total return. This model is available in U.S., EAFE and EM versions.
- **Volatility Management**, a portfolio allocated to non-traditional or "alternative investment" strategies, including equity long/short, managed futures, diversified arbitrage, short-biased and options-based. The investment objective of including this Model is to improve the overall diversification of the portfolio by including lower correlated strategies and thereby deliver more consistent performance over full market cycles.
- **Disruptive Growth**, a portfolio that, exactly as it sounds, is "hyper growth" and seeks to take advantage of evolving or disruptive trends in the workplace, platforms, cloud computing, financial technology, cybersecurity, biotech and genomics, video games and esports, and sustainable investing.

If you know WisdomTree, you know we are not a passive beta shop, even though we are an ETF shop. All our products have one or more embedded "factor tilts" —dividends, value, size, quality, earnings and so forth.

In other words, all our strategies take "active risk" relative to an underlying passive beta index—risks that we believe, both academically and empirically, have the potential to deliver alpha over full market cycles in comparison to passive beta.

Think about an actively managed mutual fund (the typical component of a satellite portfolio). What is it? It is a portfolio manager (or team) taking on active risk in an attempt to deliver net-of-fee alpha, right?

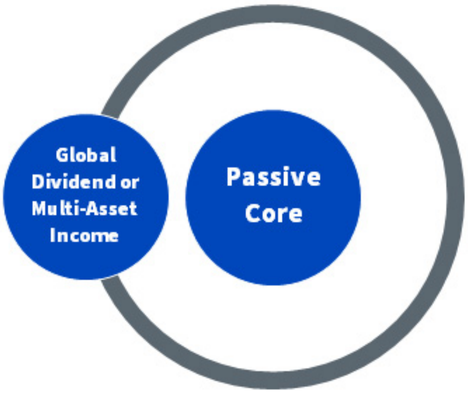
Well, that is exactly what WisdomTree does.

The difference is that our active risk bets are rules-based and quantitative in nature. We are one of the few asset managers that self-indexes—we define a quantitative and rules-based filter or screen for a given product, develop an Index around those defined screens and then wrap an ETF around that Index.

So, in many respects, despite being an ETF shop, most of our products are more accurately compared to actively managed mutual funds than passive beta products. We typically will be more expensive than the passive beta product but much less expensive than the more comparable mutual funds, while taking on similar active risk.

So, let's visualize some potential core/satellite portfolios using WisdomTree Outcome Focused Models versus actively managed mutual funds.

1. Purpose of the satellite is to optimize risk-adjusted income



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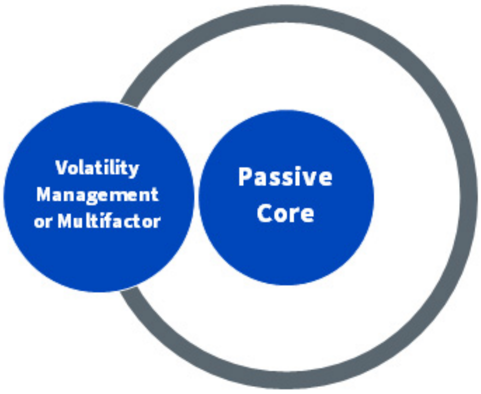
2. Purpose of the satellite is to increase the overall diversification of the portfolio:



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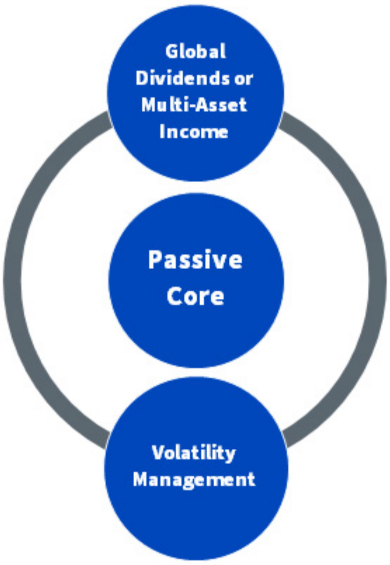
3. Purpose of the satellite is to optimize risk-adjusted income and overall portfolio diversification:



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The beauty of core/satellite portfolio construction is that the possibilities are endless—you can construct the satellite portfolio with a myriad of investment objectives and populate accordingly.

We built our suite of Outcome Focused Model portfolios with this flexibility in mind. They are designed and managed to address a number of potential investment objectives and can be mixed and matched to meet multiple objectives. A primary purpose in doing so is to optimize active management fees and make core/satellite portfolio construction easy to implement using what we believe is a more cost- and tax-effective approach—a "better mousetrap."

Optimizing Tax Efficiency

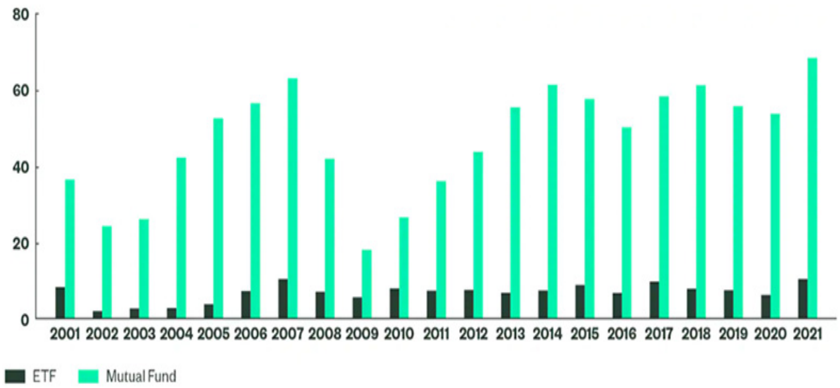
Tax efficiency is the second step in the "controllable alpha" aspects of portfolio construction. There are two levels of tax efficiency that advisors should be cognizant of—the investment wrapper level and the client account level.

We already highlighted the investment wrapper—ETFs have historically paid fewer capital gains than their mutual fund peers.

How does this lead to alpha?

A study by finance professors at Villanova and Lehigh universities quantified that an ETF's tax burden was 0.92 percentage points less than the typical mutual fund over the past five years. The following chart is from Morningstar:

Percentage of Funds Paying Capital Gains in Calendar Year (%)



Source: Morningstar, as of 7/31/22, based on SPDR Americas Research Calculations.

The second level involves the client account—specifically the tax lots of the ETFs, mutual funds, bonds, stocks, etc. The tax management of accounts involves tax-loss harvesting, tax-aware transitions and tax-aware withdrawals. These services can be quite complex.

The good news?

Active tax management of portfolios is no longer the exclusive territory of high net worth clients with access to SMAs.

Advisors can now access technology platforms that perform tax portfolio transition services and then ongoing active tax management of the overall portfolio.

WisdomTree partners with a variety of trading platforms that can and will engage in tax management of ETF portfolios. Advisors can work with these platforms to transition existing portfolios into the desired portfolio in a tax-efficient manner based on client objectives and constraints, and then actively tax manage the new portfolio on a go-forward basis.

How does this lead to alpha? The FinTech platform 55ip reported that for accounts that used its ActiveTax Technology® overlay for all of 2020, advisors generated an estimated average of 2.58% in tax savings for their clients.[4]

To summarize, WisdomTree's ETF structural bias, the active risk embedded into all our factor-tilted strategies and our partnership with technology platforms that enable active tax management of portfolios all combine to help advisors optimize the two things they have the most control over from an investment perspective—fees and taxes.

For those interested in learning about the rest of the habits, please keep an eye out for the other three blogs and make sure to read the entire white paper: "Four Habits of Highly Successful Advisors."

[1] With respect to Dr. Stephen Covey for his The Seven Habits of Highly Successful People, Simon & Schuster, Anniversary Edition, May 2020.

[2] The seminal paper on active risk is "How Active Is Your Fund Manager" by Martijn Cremers and Antii Petajisto, first published as a working paper in 2006. It can easily be found by searching on the title and authors.

[3] 2021 U.S. Fund Fee Study. https://assets.contentstack.io/v3/assets/blt4eb669caa7dc65b2/blt36de8b5594de0582/62c6e888181754349ea2fa66/U.S._Fund_Fee_Study_2021.pdf

[4] https://www.wisdomtree.com/blog/2021-03-19/the-so-called-certainties-in-life-seem-a-lot-like-mutual-funds

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DEFINITIONS

Beta : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

Alpha : Can be discussed as both risk-adjusted excess return relative to a specific benchmark, or absolute excess return relative to a benchmark. It is sometimes more generally referred to as excess returns in general.

Separate account : An investment portfolio owned by an investor and managed by a professional investment firm—typically registered investment advisors (RIA). Also known as separately managed accounts (SMAs),

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

MSCI ACWI Index : A free-float adjusted market capitalization-weighted index that is designed to measure the equity market performance of developed and emerging markets.

Expense ratio : The annual fee that all funds or exchange-traded funds charge their shareholders